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International Quagmire

"For the French elite, money is not the lubricant of the economy but the most important lever of power. Capture of the Bundesbank is thus for them the great prize in the European monetary war. To secure it, they have been willing to tempt Germany with the lure of political union, while never intending to deliver it."

*The Rotten Heart of Europe
Bernard Connolly, 1995*

The renewed turmoil in European currencies and stock and bond markets reflects worries over a broad range of issues, from political trouble in France, Italy, Britain and Spain, to continued doubts over the Maastricht Treaty criteria for European Monetary Union. But the central, aggravating factor threatening to turn these currency shivers into a currency crisis is the ailing dollar, which suffers from massive oversupply. Political uncertainty in Europe is the excuse for, not the cause of, the dollar's woes.

In the wake of mid-August's "successful" coordinated dollar intervention by the central banks, bullishness towards the U.S. currency promptly went wild again. Forecasts of a steady climb towards DM 1.60 were universal. Instead, the dollar once again is near its record lows. Its gains against the yen have been held only because the Bank of Japan has provided steady and virtually unlimited support.

Once more the dollar bulls have been caught out, yet a stubborn belief that the U.S. currency must sooner or later rise from the ashes remains predominant in the market.

Meanwhile, there can be no doubt the world economy, except for the Far Eastern developing countries, is slowing. The most remarkable aspect of this global slowdown is that it has happened in the absence of any monetary tightening. Such a distinctly anemic business cycle reflects, in our opinion, deeper-seated impediments to economic growth, primarily insufficient savings and investment versus an excess of unproductive debt.

In this letter, we explain in detail why U.S. monetary policy, despite a shrinking monetary base, is of unprecedented looseness. Credit is on a rampage. Bank credit growth, in particular, has more than doubled since a year ago. At the opposite extreme is Japan's banking system. All of the Bank of Japan's interest-rate cuts and liquidity infusions so far have been thwarted by the banks' unwillingness or inability to expand credit.

We have contested the widespread idea that, in the wake of the Bank of Japan's recent monetary easing, a wall of money from Japan is poised to flood the world financial markets. If anything, the opposite appears to be the case. What the Japanese banking system is struggling with is not a shortage of bank reserves but a shrinkage of collateral values and a general loss of confidence in the banks. This prevents any credit expansion, regardless of the Bank of Japan's reserve injections.

Now Japan's banking crisis has taken an even more frightening turn with the appearance of a rising "Japan premium" on the borrowings of Japanese banks in the Euro-interbank market. Given the mini-spreads typical in international credit markets, these extra costs are forcing the banks to retrench even more. Worse still, some international lenders are curtailing their credit lines to Japanese financial institutions.

All this easily could snowball and provoke a liquidity crisis, triggering upheavals throughout the international financial system. In light of these risks, we are astonished that the Japanese authorities have not acted more vigorously to nip this "Japan premium" in the bud.

WAITING FOR LOWER INTEREST RATES

Misplaced hopes that the G7 finance ministers and central bankers would say or do something at their recent meeting in Washington that might give the U.S. dollar's recovery a new impetus have been disappointed. What they actually delivered was the customary ritual statement that they like and desire a strong dollar.

While U.S. Treasury Secretary Robert Rubin refused to say that the U.S. currency's most recent rise had taken it far enough to satisfy U.S. policymakers, Japanese and German officials were more forthcoming in stating that it ought to be higher still. Hans Tietmeyer, president of the Bundesbank, explicitly argued that "the present value of the dollar is not fully reflecting the fundamentals of the situation."

One can only wonder what Dr. Tietmeyer regards as the "fundamentals of the situation." Did he refer to the grossly discredited doctrine of purchasing-power parity? To be sure, he couldn't have been looking at the monstrous gaps in the U.S. balance of payments, which are flooding the rest of the world with dollars. Since we wrote extensively about these dollar outflows in our last letter, it may be enough here to recount them in a nutshell: At an annual rate, the United States had in the first half of this year a trade deficit of \$188 billion, a current-account deficit of \$165 billion, and capital outflows of \$300 billion. Given this international dollar deluge, the only thing to wonder about is how anybody can be surprised by the dollar's continued weakness.

What next? Volatile markets suggest nervousness and confusion among investors. But overall, the tone remains bullish. As the global slowdown becomes more apparent, markets look forward to further rate cuts by central banks. Adding to the bullish mood have been signals from the Federal Reserve that it would respond to deficit reductions made by Congress by cutting rates, and panic buying of bond futures by holders of callable mortgage-backed bonds.

This last influence, it may be recalled, also was a major factor behind the bond-price volatility of 1993-94. This time around, a panicky reaction was triggered when the 10-year note's yield slipped below 6%, a level that many holders of mortgage-backed securities viewed as the trigger point for a new round of refinancing by homeowners. This implies that investors are about to get some of their principal back, leaving them with the disagreeable task of reinvesting those funds in lower-yielding securities. To hedge against this potential shortening of their portfolios, mortgage investors bought Treasury futures.

Actually, the economies of the industrial countries are leaving behind them the most anemic of cyclical recoveries. In Europe, it lasted barely two years and already is peaking, having made hardly a dent in the high level of unemployment. With its economy now in a fifth year of growth, the United States definitely has performed the very best among the OECD countries. But against the backdrop of very loose U.S. monetary policy, it has required unprecedented volumes of U.S. dollar and bond purchases by foreign central banks to keep the economy and the financial markets on an even keel. Otherwise, a catastrophic dollar crisis probably would have choked both the recovery and the financial bull markets a long time ago.

Despite all, international agencies seem to be forecasting an ideal scenario for ongoing bull markets in bonds and stocks: They predict a "Goldilocks" world recovery – not too hot, not too cold – with world GDP growth of 3.7% this year and 4.1% next year. The only trouble with this golden scenario is that all of the acceleration is expected to happen in the developing countries of the Far East, while growth in the industrial countries is likely to be successively downgraded. Yet most economists hail slower growth as the most bullish possible development for the financial markets. The World Equity Index in recent weeks has set a new all-time high, bonds largely have recovered from their slump last year, and the stock of securities around the world has virtually exploded, soaring from only 56% of world GDP in 1983 to a high of 137% at the end of 1994.

A main element of the bullish secular case for U.S. bonds is that current real yields still are high relative to the 1950s and 1960s – the last period of low, stable inflation and tight fiscal policy. In those years, real longer-term interest rates indeed were 2-3%, compared with the present 3.5%. By this token, there would

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (October 27)	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia	-2.8%	8.1%	1.7%	-4.6%	13.4%
Canada	-3.7%	2.9%	1.6%	-8.0%	8.6%
France	-2.8%	-0.7%	-6.2%	-13.6%	1.2%
Germany	-4.3%	-1.7%	4.1%	-9.5%	9.7%
Hong Kong	0.3%	18.2%	4.0%	-3.5%	38.9%
Japan	-5.1%	-12.1%	-12.4%	-13.3%	19.7%
Mexico	-4.1%	-5.5%	-13.4%	-14.4%	55.2%
Spain	-4.4%	4.1%	2.7%	-9.2%	12.2%
U.K.	0.4%	14.1%	15.5%	-2.6%	18.8%
U.S.	0.2%	26.2%	24.4%	1.9%	30.1%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (October 27)	Current Rate(%)	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia	8.65	1	-134	-178	-206	37
Canada	7.85	-4	-129	-126	-183	30
France	7.32	-19	-95	-104	-111	7
Germany	6.50	-18	-112	-112	-125	7
Japan	2.99	17	-158	-190	-190	39
Spain	10.93	-2	-91	-25	-100	38
U.K.	8.09	10	-62	-66	-71	41
U.S.	6.04	-22	-178	-183	-199	11

Exchange Rates

Versus U.S. Dollar, % Change

Country (October 27)	Current Rate	Month	YTD	Y-Y	Vs. 12- Mo. Hi	Vs. 12- Mo. Lo
Australia (\$)	1.33	0.7%	-2.7%	1.5%	-3.1%	6.1%
Canada (\$)	1.36	-1.0%	2.7%	-1.1%	-2.6%	4.2%
France (f)	4.89	0.4%	8.4%	4.7%	-2.8%	10.4%
Germany (DM)	1.41	1.1%	9.1%	6.0%	-4.1%	11.5%
Japan (¥)	101.86	-1.4%	-2.3%	-5.0%	-26.3%	2.6%
Spain (Pt)	122.29	0.7%	7.1%	1.8%	-3.5%	8.9%
U.K. (£)	1.58	0.1%	0.8%	-3.6%	-3.8%	2.8%

appear to be room for a further decline of nominal long-term yields towards 5%.

All we can say is that it is a silly argument. It completely overlooks the disastrous difference in savings and budget deficits then and today. The United States had an average net savings rate (private savings minus the public-sector deficit) of 7.4% during the 1950s and 7.8% in the 1960s. This compares with a meager 3% net savings rate in 1994. Indeed, the United States was a surplus country throughout much of the 1950s and 1960s, reflecting a domestic savings surplus. Today, it is a chronic deficit country, reflecting a big shortfall of domestic savings even in relation to a fairly weak rate of net investment.

It used to be conventional wisdom among economists that in a noninflationary economy, interest rates fundamentally are determined by the supply and demand for savings, credit demand being in the last analysis a demand for savings. Keeping the two in equilibrium is (or should be) the function of interest rates. If the flows of loanable and investible funds are in excess of available savings, interest rates have to be high or rising. If savings are in excess, interest rates have to be low or falling. That was the core of classical interest-rate theory.

In the United States, as we repeatedly have explained and stressed, the total flow of funds into domestic and foreign financial markets is monstrously in excess of domestic, new savings. Current borrowing by the non-financial sector (government, businesses and consumers), now is running at an annual rate of more than \$800 billion, compared with business and personal savings totalling only about \$330 billion. Given such a tremendous excess of credit demand, the equilibrium interest rate probably is somewhere between 8-9%.

It takes a theory to destroy a theory. The man who dethroned savings as the key fundamental on the supply side of the financial markets was John Maynard Keynes. He postulated that interest rates had nothing to do with savings or credit demand, but instead are determined in the market for money, or more precisely, by the confluence of monetary

policy, expectations and the resulting bearishness or bullishness with regard to securities – in other words, by the liquidity preference of investors.

To Keynes, the greater part of the demand for securities in a bull market comes neither from current savings, nor from current money growth, but from the total money stock in existence, as investors switch out

of money and into securities. From this perspective, the potential supply of loanable and investible funds has virtually no limits. All that is needed to lower interest rates to any desired level, regardless of available savings and credit demand, is easy money and a declining liquidity preference, causing a mass move out of money and into bonds and stocks – the now famous dash from cash.

THE KEYNESIAN ERROR

Wasn't Keynes magnificently right, when we consider how the U.S. financial markets have boomed the past 12 years, even though U.S. net savings have plunged? Yes and no. He was right in stressing the possibility that a major move of investors out of their money holdings and into bonds would reduce interest rates, irrespective of savings. Yet he was utterly wrong in presenting this as a "general" theory. Like everything else with Keynes, it was a short-term theory. Such a flight from cash essentially has undesirable side effects. Above all, it simply is not sustainable in the long run.

As we mentioned in our last letter, the economists of the classical school who opposed Keynes used a sophisticated analysis of total flows of loanable and investible funds in order to check any inflationary trends in the economies or the markets. To this end, they distinguished strictly between flows from savings and flows from inflationary sources. Actually, Keynes himself came from the same school of thought – the loanable funds theory of the Cambridge School.

But the flight from cash which Keynes hailed as an economic blessing was in the eyes of the classical school an inflationary disturbance that a central bank could and should monitor and resist. For them, the relevant fact was that a declining demand for money holdings, or its inverse, a rise in the velocity of circulation, fueled higher spending and hence higher prices, just as much as a rising money supply. It made no difference to them whether the resulting inflation took place in the prices of goods and services or in the prices of financial assets. Armed with this concept, they had no trouble identifying speculative bubbles.

Common to the entire Cambridge School, including Keynes, was the notion that the relevant monetary aggregate to be focused on in the case of such a change in desired money holdings was the total money stock in existence, and not only its small current growth.

However, when we speak of a "flight out of money" into securities, we must realize that the money thus spent does not vanish. There can be no withdrawal of money from the banking system. Existing bank deposits change hands between buyers and sellers, that is all that happens. Nevertheless, the liquidity of the public diminishes as the value of the inflating, illiquid securities increases out of proportion to the liquid money stock. What progressively sinks is the liquidity ratio. This portfolio shift already has had rather dramatic effects on the financial balance sheets of U.S. households.

True liquidity, measured as the proportion of financial assets on the balance sheets of individuals held in the form of cash or cash equivalents, is at an all-time low. Increasingly, Americans have moved their savings into securities and into institutions such as pension funds and insurance companies, which also invest overwhelmingly in securities. This trend has had its counterpart in a progressively falling ratio of liquid assets, from 34.9% in 1980, to 27.6% in 1990, to less than 20% of total financial assets now.

The present bull run of U.S. bonds started on November 4, 1994, with the 10-year note yield at 8.03%. Now it is down to 5.96%, making for a fall of more than 200 basis points in barely eleven months. What has happened to explain or to bear out this sharp decline in long-term rates? It definitely has nothing to do with any improvement in the balance between U.S. savings and credit expansion. Non-financial debt growth actually has soared from \$602 billion in 1994 to a \$830 billion annual rate in the first half of 1995, a stunning increase of more than one-third.

Who were the big buyers who drove this new bull run of U.S. bonds? Comprehensive data, compiled by the Fed in its quarterly Flow of Funds report, confirm what we pointed out in our last letter. In general, U.S.

investors completely missed the bond rally. Most of them were net sellers of Treasury bonds during the period, except for pension funds and (the main American buyers) brokers and dealers. On balance, U.S. buying was zero. The increase in demand that drove the rally came entirely from foreign central banks, foreign banking offices in the United States and foreign investors.

Foreign entities, mostly central banks, acquired Treasuries at an annual rate of \$180 billion in the first half of this year. These purchases largely reflected the recycling of dollars acquired in support operations by central banks on world foreign exchange markets.

How did U.S. brokers and dealers finance their own huge bond holdings? By collateralized borrowing in the so-called repo market. In this market, borrowers sell the bonds they have purchased to an institutional investor with an agreement to repurchase them at a fixed price on a fixed date. Whenever they want to sell the bonds, they undo the repo. From a monetary perspective, the significant point is that the money borrowed and lent in this way does not come from banks but rather from nonbank investors who lend some of their bank deposits. Consequently, there is no growth in the money supply. Existing money is more intensely used.

In October 1993, at the very height of the bond bubble, primary dealers alone had open repos in government securities of \$852 billion, equivalent to 30% of U.S. marketable debt outstanding. Actually, the vast standardized repo is today in the United States the main instrument for funding speculative positions in the financial markets.

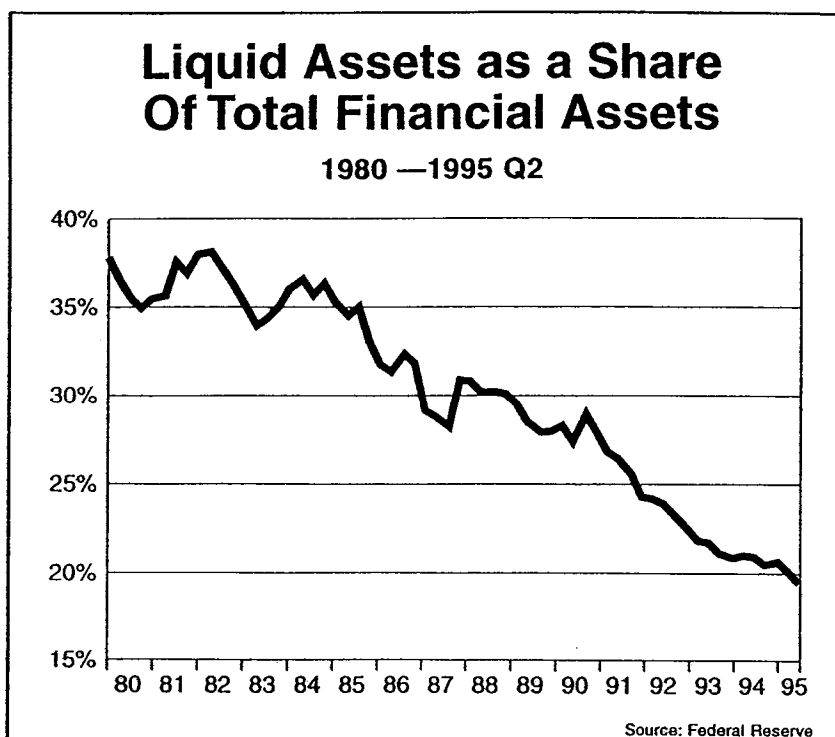
We mention this in order to make one point clear: The U.S. financial system in general and the bond market in particular have completely decoupled from current savings as a source of finance. They are uniquely geared to unlimited financial leveraging with borrowed money. The key point here is the tremendous ease with which huge speculative position can be funded.

UNRAVELING EMU

On the face of it, Europe's politicians have put an end to the uncertainty over the plan for European Monetary Union (EMU) by reaffirming both its original starting date of January 1, 1999 and their commitment to respect the convergence criteria of the Maastricht Treaty.

Not surprisingly, financial markets are not quite ready to accept these resolutions at face value. A sudden, sharp widening of interest-rate differentials on long-term debts between currencies in Europe has highlighted the credibility gap between what the governments declare and what the markets believe is realistic.

At risk in Europe is primarily the French franc, as markets increasingly doubt the government's ability to slash its budget deficit enough to comply on schedule with the Maastricht convergence criteria. But any further weakening of the dollar probably would impair even more currencies.



Though not a single word of the Treaty has been altered, something of crucial importance has changed. It concerns the question of how the entry conditions for EMU will be treated in the end: strictly or liberally. The trigger for the recent agitation on this point was a surprising remark by the German Finance Minister, Theo Waigel, to the effect that Italy definitely will not be able to meet the criteria for joining monetary union in 1999. At 120% of GDP, its accumulated public-debt ratio is double the level permitted by Maastricht.

Diverging in Europe		
Basis-point spreads over 10-year German government bonds		
	September 1	October 24
Belgium	49	57
France	68	103
U.K.	141	169
Spain	436	448
Italy	491	578

More shockingly, Mr. Waigel's caveats were not confined to Italy or even to Belgium, whose debt ratio of 136% is even higher than Italy's but which politically would be much harder to exclude from instant membership. He even included the Netherlands (the most faithful adherent to parity with the mark of all EU countries) on the list of countries which might not meet the target, given its debt ratio of 79%.

What Waigel expressed actually has been glaringly obvious from the day the treaty was signed, namely, that the majority of the countries involved have no chance in hell of meeting all the criteria, particularly the fiscal components, by 1997. The inherent implication is that the politicians right from the start had a hidden agenda for cheating on those conditions – the customary Eurofudge.

THE GERMAN PUBLIC IS STIRRING

But Waigel's remarks point to the fact that German politicians no longer can simply ignore the anxiety and indignation among the electorate about their intention to sacrifice the stable DM for an untrustworthy common European currency. As the date for the start of the new currency draws uncomfortably nearer, long smoldering worries now are readily vented. Late, but not too late, the German public is stirring.

Being himself a firm advocate of monetary union, like all German politicians, Waigel apparently wanted to convey the impression that people could trust their government not to permit the slightest deviation from the Maastricht criteria. Without cheating, however, the Maastricht Treaty is dead.

The trouble is that under the treaty it is not up to Germany alone but to a "qualified majority" among the 15 members of the European Council to decide whether or not a country is fit for entry into EMU. As it turns out, the treaty itself is anything but strict in the application of the criteria. For example, though it stipulates that the current budget deficit in the member states must not be higher than 3% of GDP, it allows this level to be exceeded if the ratio has declined "substantially...and reached a level that comes close to the reference value." Another article says that government debt may exceed 60% of GDP if "the ratio is sufficiently diminishing...at a satisfactory pace."

The meaning of "substantially," "close," "sufficiently," and "satisfactory" is for the Council of Ministers to decide. In light of these equivocal formulations, it generally has been assumed that the high-deficit and high-debt countries would need only to make some reductions in their current deficits – as a sort of good-faith gesture.

Italy was the first to present to the Council of Ministers a medium-term convergence program. The program, submitted in late 1991, projected a rapid reduction in the central government's borrowing requirement from an estimated 10% of GDP in 1991 to 5.5% in 1994. The actual outcome was closer to 9%.

Given the broad, pro-EMU consensus among politicians in Europe, the markets initially considered it a foregone conclusion that the Treaty would be ratified and implemented. Linked to this was a firm conviction in many minds that after five years of virtual exchange-rate stability in Europe, the existing European Monetary System already was a *de facto* monetary union with quasi-fixed exchange rates. The Maastricht provisions for convergence seemed to make this all the more certain.

DECEPTIVE STABILITY

Blinded by the EC's commitment to exchange-rate stability, international investors and speculators poured money into the high-yielding currencies, viewing them as profitable proxies for the German mark. In essence, this amounted to a huge bet that the transition towards EMU, by equalizing interest rates, would produce big capital gains on the high-yielders, with zero risk of currency depreciation.

Preposterously, this perception and the associated capital flows sent the currencies of the countries with higher inflation and interest rates to the top of the EMS currency band, while the low-yielding strong currencies languished at the bottom. Instead of imposing monetary discipline on the high-inflation, high-deficit countries, pegging their currencies had the opposite effect. Excessive capital flows financed excessive consumption, fueled speculative bubbles and boosted current-account deficits. Today, most of these economies are sicker than before.

What most people completely failed to realize was the fact that this amazing facade of prolonged exchange-rate stability in Europe concealed the emergence of tremendous imbalances and currency misalignments that one day would burst into the open. But these inconsistencies were ignored by financial markets so long as the EMU project remained unquestioned. In the last analysis, this ill development had two main roots:

- ▶ A sky-rocketing fiscal deficit, strong wage cost pressures and a sharply deteriorating trade balance in Germany. All three factors, stemming from the unique circumstance of German reunification, demanded prolonged monetary tightness.
- ▶ A general obsession outside of Germany, particularly in France, with fixed exchange rates as a precursor to European Monetary Union.

With the floor to nominal interest rates held high by Germany, quite a few countries resorted to deficit spending to stimulate economic growth. All too ironically, "Euro-exchange rate" discipline thus led to heightened fiscal irresponsibility. EU countries that have run soaring budget deficits in the last few years include Britain, Austria, Denmark, Finland, Spain, Sweden and France.

In general, this run-up of budget deficits was excused as the inevitable result of the weakness of the European economy in 1992-93. This is partly true, but it should be noted that Germany managed to sharply reduce its budget deficit, despite fiscal transfers to East Germany running at an annual rate of around 5% of GDP.

The day of reckoning for the currency markets started with the narrow rejection of the Maastricht treaty by the Danes on Sunday, June 2, 1992. This caused the first real crack in the perception of permanent exchange-rate stability and a smooth transition towards EMU. The markets instantly repositioned themselves. As "convergence plays" were unwound, huge amounts of money fled in particular from Italy and Spain to the safe haven of the DM.

THE WORST CURRENCY CRISIS EVER

What followed was the worst currency crisis ever, both in terms of the amounts and numbers of currencies involved, lasting from September 1992 to May 1993. Together with the U.S. and Canadian dollars, a total of seven ERM and three pegged Nordic currencies experienced repeated, heavy selling waves and deprecia-

tions, mainly against the DM. Overall, some of the currencies fell more than 30%. An April 1993 report by the Group of Ten put the figure for total European central bank net sales of the mark at DM 284 billion during this period, of which DM 188 billion was used to defend ERM currencies.

In hindsight, this revolving currency crisis of 1992-93 looms as the most widespread and most violent exchange crisis of the whole postwar period. The only currency saved from a threatening plunge, owing to virtually unlimited German support, was the French franc. Yet the franc appears increasingly vulnerable now. The *franc fort* policy has lost some of its credibility, causing growing doubts that the French authorities will deliver what they say.

These doubts begin with the dismal trend in the French budget deficit. When the Maastricht Treaty was signed in 1991, this shortfall was just 2.2% of GDP. Two years later, it was 6.1%. Since 1990, French government spending has soared from 50.5% to 55% of GDP – one of the highest levels of any industrial country. What's worse, when economic growth last year proved stronger than expected, sharply higher tax revenues were not used to reduce the deficit, but rather to increase spending. Year after year, there have been considerable spending overshoots. Without large, one-time privatization receipts, the budget shortfall might well have reached 7% of GDP.

As the European economy now is slowing, all countries are facing crunches in their tax receipts that will make deficit reduction even more difficult. To achieve the Maastricht target by 1997 will require vigorous pruning of social spending and the public-wage bill. France has by far the highest government employment in the OECD area, accounting for close to 23% of the total work force, as compared to 15% in Germany and in the United States. For years, the take-home pay of public officials has been rising much faster than for private-sector employees.

A main victim of the *franc fort* policy, with its soaring budget deficits, has been investment spending. This fell more than 10% from 1990 to 1994, and has staged only a modest recovery since then. Manufacturing investment has been particularly weak.

Gross Private Fixed Capital Formation As Percent of GDP At current prices

	1974-85	1986	1987	1988	1989	1990	1991	1992	1993	1994
France	18.8%	16.1%	16.7%	17.4%	17.9%	17.7%	17.3%	16.4%	14.9%	14.7%
Germany	17.6%	16.9%	17.0%	17.2%	17.8%	18.6%	19.1%	18.9%	18.0%	18.3%

Source: Commission of the European Communities

This investment weakness is all the more striking considering the current financial situation of French companies is exceptionally favorable compared to previous recoveries. Acceleration of growth, continuing wage restraint and the sharp fall in financial costs markedly improved company profitability in 1994, so that the self-financing ratio attained the very high level of 115%. The main impediment to manufacturing investment appears to be the very high output gap, as seen in the sharp decline in capacity utilization.

The two sets of figures above go a long way to explain one critical, fundamental variable in the recent development of the French and the German economies: the difference in investment performance.

Unemployment is the other outstanding negative of the French economy. Between 1990 and 1994 it surged from 8.9% to 12.3%. Though presently down to 11.6%, it would have risen far higher during the last recession if not for an acceleration in government hiring, reflecting the rapid expansion of public-jobs programs.

How best to describe the French economy's recent performance? We would say it has been near-disastrous, considering the extraordinary weakness in investment and employment. Definitely, it is not a strengthening but rather a weakening economy.

For good reasons, financial markets remain doubtful that the French government will manage to make the budget cutbacks required to qualify on time for EMU. We share these doubts. But we wonder even more whether the French politicians even are interested in the formation of a small "hard core" monetary union, consisting mainly of the DM-bloc countries and France. The smaller the group, the less the chance for France to dominate it.

EURO-ANOMALIES

This letter always has forewarned that the frenzied boom in the high-yielding, soft-currency bonds was a bubble that had to burst one day. Indeed, this bust provided the key prologue to the ERM crisis in 1992-93. After the global bond recovery of 1995, recent months have brought new, sharp setbacks.

But if there is a rush underway into the DM, it isn't showing up in lower German bond yields. The reason most often cited is that the German public, fearful of a common European currency, is shunning maturities beyond 1999.

No less odd is the appearance of the German yield curve. It's the steepest of all among the industrial countries, with a differential of 247 basis points between a 4.03% Bundesbank repo rate and a 6.50% yield on 10-year Bunds. This compares with a corresponding U.S. yield differential of barely 29 basis points, given a federal-funds rate of 5.75% and a 10-year Treasury yield of 6.04%.

Why are U.S. long-term yields so much lower than comparable German yields, even though Germany has much better fundamentals both in terms of available domestic savings and inflation?

The customary explanation for a steep yield curve is that it reflects either high inflationary expectations, a strengthening economy, or both. A flat yield curve, on the other hand, is supposed to express monetary tightness and low inflationary expectations.

But this explanation doesn't fit the current situation in either the United States or Germany. The German economy is weakening, despite the Bundesbank's repeated rate cuts. Thus, its next move can only be down, particularly in the face of the strong DM. Inflation rates in both countries have steadily declined, but the German year-over-year rate of 1.5% is well below the U.S. rate of 2.5%.

THE ARCH-CONSERVATIVE GERMAN INVESTOR

The favorite explanation for this puzzle is that the impending abolition of the DM has put a risk premium on German long-term bonds. While we wouldn't completely dismiss this point, we hasten to add that in historical terms present Bund yields appear quite reasonable. The lowest yield ever on 10-year Bunds over the past 30 years was 5.7%. This compares with an average yield of 7.74% and a peak yield of 10.83%.

Historically, the German private investor turns leery whenever longer-term yields fall below 7%. From that point on, he leaves it to the smarter banks and the even smarter foreigners to burn their fingers. In the bond bubble of 1993, foreigners accounted for 59.8% of total net purchases of German bonds, and domestic banks for another 37.2%, but German nonbanks purchased only a miserable 3%.

In 1994, by contrast, when bond prices plunged and yields soared, German nonbank investors bought 44.5% of the net supply of bonds, while the share purchased by foreigners plunged to only 4.5%. Neither year reflects much credit on the investing talents of the latter group.

This year, once again against a background of falling yields, the most significant development has been the sharp slowdown in German domestic nonbank bond purchases in recent months. Banks have even turned into net sellers, apparently locking in some of the profits generated by the bond rally. The big buyers have been foreigners.

Ironically, that trend was paralleled in the U.S. bond markets in the first half of this year. Of total net issues of some \$167 billion in U.S. Treasury and Agency bonds, foreign central banks and investors absorbed about two-thirds. American entities were net sellers of Treasuries and net buyers of Agency bonds.

U.S. RATES ARE THE TRUE ANOMALY

That German long-term rates should exceed corresponding U.S. rates is distinctly anomalous. But where, exactly, is the anomaly? Are German rates too high, or are U.S. rates too low? For us, the latter unquestionably is true. We see two main reasons: One is the persistent, heavy demand from foreign central banks, and the other is the vastly superior role of leveraged speculation.

The crucial role of foreign central banks in the ongoing bull market in U.S. bonds, with positive feedbacks to stocks, cannot be stressed often enough. Countries with high external deficits generally have high interest rates. But in the case of the United States, foreign central banks have turned this rule upside down. They support the U.S. markets indirectly by keeping the dollar from slumping, and directly through associated, heavy bond purchases. The alternative is a dollar collapse that would play havoc with U.S. bonds and stocks.

In the last analysis, foreign central banks sanction and foster the Fed's extremely loose monetary stance. The resulting low interest rates and booming financial markets have saved the U.S. economy from recession. But by the same token, monetary looseness has perpetuated the vicious circle of an outsized U.S. current-account deficit and large capital outflows, which have so weakened the dollar.

We realize our view of U.S. monetary policy as being excessively loose is not at all shared in the markets. In the consensus view, Fed policy is mildly restrictive, which is to say just about right. The monetarists, meanwhile, call it dangerously restrictive.

A look at the monetary aggregates makes these contradictory views comprehensible. They indeed show an unprecedented divergence. Measured by the monetary base (consisting of currency in circulation and bank reserves) and M1, the traditional gauges of most American monetarists, the Fed's monetary stance is tight as never before. But measured by credit and debt growth, it is loose as never before.

What a muddle! The figures prove anything or nothing. Which of the two aggregates is the appropriate gauge of monetary policy?

Our answer: credit and debt. Controlling credit expansion is the essence of monetary policy. In America, the credit machine is running full speed, without any constraint. Nonfinancial debt has been growing three times as fast as nominal GDP and more than seven times as fast as real GDP.

The resulting debt-to-GDP ratio of 3.25-to-1 makes for the biggest ever "overhang" of credit

Growth of U.S. GDP And Financial Aggregates

First half 1995

Nominal GDP	+ \$127.7 billion
Real GDP	+ \$51.4 billion
Bank Reserves	- \$1.99 billion
M1	- \$4.2 billion
M3	+ \$153.3 billion
Debt*	+ \$415.5 billion

*Debt growth of nonfinancial sectors

Source: Federal Reserve

expansion relative to GDP growth as the national account measure of economic activity. Until the late 1970s, that ratio hovered in the neighborhood of 1.3-to-1.

MANUFACTURING MONEY

But what about the declines in M1, bank reserves and the monetary base? Why are these aggregates so extremely weak? In short, their weakness stems from profound structural changes in the U.S. financial system, changes which have disrupted the former link between credit and money creation.

True, the Fed has reduced available bank reserves, which tends to have a restrictive effect. Yet its reserve stance in terms of excess reserves remains as accommodative as before. Rather, the Fed is responding to lower reserve demand caused by the shrinkage of sight deposits, which alone are subject to reserve requirements. As the table above shows, banks nevertheless have more than doubled their loan expansion in 1995.

Growth of U.S. Bank Credit (1995 Q1 and Q2 at annual rates)

1990	\$130.2 billion
1991	\$105.7 billion
1992	\$115.9 billion
1993	\$163.9 billion
1994	\$157.0 billion
1995 Q1	\$335.5 billion
1995 Q2	\$336.2 billion

Source: Federal Reserve

Ordinarily, bank credits and bank deposits rise in lockstep. An expanding asset side of the balance sheet implies a commensurate expansion of the liability side. The same reasoning applies whenever a bank makes a loan. It gives the borrower a credit line on its books. As the borrower draws checks on this credit line, he transfers money to the deposit account of his creditor, which most certainly is with another bank. As a result, the sum of bank deposits is increased. So the loans of one bank make the deposits of others. The key point is that money in the form of bank deposits is manufactured by bank loans and investments.

Given this casual link between the banks' credits and deposits, broad money growth used to be a close proxy for bank credit growth. But this is no longer the case. American banks have increasingly turned to funding sources that are not counted as part of the money supply. Last year, for example, the banks were driven to replace lost domestic deposits with Eurodollar deposits. This year, a major shift back into funding with domestic deposits is spurring broad money growth again.

What's more, sweeping structural changes in the U.S. financial system since the early 1980s have dramatically curtailed the role of banks and thrift institutions in the lending process. Financing has steadily shifted away from banks to other financial intermediaries and above all to the securities markets. Banks and thrifts have seen their share of total assets of financial intermediaries plunge from 57% to 35%. They hit a record low of 22% in the early 1990s.

From a monetary perspective, this structural break has had a striking side effect, namely, an unprecedented divergence between debt creation and liquidity creation, since only bank lending creates money. That's really the key reason why the money supply no longer makes any sense as a measure of the Fed's monetary stance. Since 1990, a massive rise in nonfinancial indebtedness of \$2.7 trillion compares with broad money growth (M3) of just \$330 billion. Almost half of that money growth occurred in the first six months of 1995.

This still leaves us with the pertinent question of why these exorbitant credit excesses relative to GDP haven't shown up in higher consumer prices. There is only one explanation. Along with the structural break in the U.S. financial system, there also has been a structural break in the use of money and credit – away from goods and services, and towards financial assets. The demand pressures brought about by ultra-easy money and overabundant credit now are “concentrated” in these markets. The emphasis on borrowing has switched from investment in fixed capital to investment in bonds and equities. Just one example: Over the twelve months ending mid-1995, U.S. corporate debt growth of \$186 billion compared with corporate net-equity purchases of \$77 billion.

U.S. CONSUMER LIQUIDITY STEEPLY DOWNHILL

The purpose of our analysis, of course, is to interpret events and draw conclusions from them. It is Wall Street's mantra that the Fed has vanquished inflation and that this has laid the groundwork for bullish financial markets to extend as far as the eye can see. Our analysis of the underlying facts, in terms of actual credit and money flows, reveals instead that there are various awesome imbalances in the U.S. financial system that are both inconsistent and unsustainable in the long run.

In Japan, it was the corporate sector which overextended itself during the bubble phase of the late 1980s. In the U.S. case, the private household sector has overreached. Its net liquidity, as measured by the ratio of liquid assets to debts, has deteriorated progressively and dramatically since the early 1980s. In 1982, liquid assets (bank deposits and money-market fund shares) of \$1.9 trillion exceeded debts of \$1.625 trillion by a large margin. Since then, indebtedness has roughly tripled to \$4.959 trillion, while liquid assets have risen far less, to \$3.221 trillion.

This rapid depletion of household liquidity has two distinct reasons. First, it reflects heavy borrowing to finance overconsumption. Second, there has been a massive portfolio shift away from liquid assets and towards illiquid investments in bonds and stocks.

We readily admit that we have been more than astounded by the extremes to which this rush into debt and illiquid investments has gone. But we think the safest thing to say is that this bull run is in its late stages. It literally is living on borrowed time.

CONCLUSIONS

Given a general slowdown of economic growth in the industrial countries, more monetary easing is in the offing. In the short run, this prospect essentially is supportive for the financial markets. But their tremendous volatility warns of vehement speculation. Everywhere, the engines of growth rapidly are losing power. We think any surprises will be on the downside.

Inflation in the prices of goods and services will continue to dwindle. Inflation in financial-asset prices certainly has lost momentum. We favor caution.

Japan's economic weakness and financial squeeze, and the huge U.S. international imbalances, are major, potentially destabilizing influences on the global economy. In both cases, there is little evidence of improvement.

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